

Capital structure with Conflicts of Interests



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Why conflicts of interests?

- The Public Corporation:
 - Separation of ownership and control (i.e. conflicts of interest between managers and shareholders)

Who are the shareholders in public corporations?

- **Individuals.** Most individual investors own small stakes and their holdings are very diffuse. The free rider problem. The presence of individuals is declining.
- **Institutional investors.** Pension plans, insurance companies, banks, and mutual funds control about 50% of corporate equity (eighty percent of trading volume). Institutions have typically played a very passive role. **Pension plan passivity may be changing.**

Why Public Corporations?

- **Project Size and Financial Constraints.**
- **Diversification.** Our conclusion that only systematic risk is priced is only true if ownership of an asset can be spread across many investors.
- **Managerial Expertise.** Once the size of corporations grew beyond a few investors, it was no longer possible for all of the owners to be involved in the operations of the firm. Managers are hired because they are experts at managing large enterprises.

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Possible Managerial Incentives in Public Corporations (other than max shareholder value)

- **Maximizing other stakeholders interests**
- **Exerting low level of effort**
- **Maximizing non-pecuniary benefits.** Managers set their own perks (e.g. cars, country club memberships, health benefits, life insurance)

Non pecuniary benefits, an example

	CEO's Equity Stake	NPV of Jet Purchase	CEO's Personal Valuation of Jet	Cost to CEO	Purchase Jet?
Firm A	.25%	-\$15 Million	\$100 K	\$37,500	Yes
Firm B	100%	-\$15 Million	\$100 K	\$15 Million	No

Warren Buffet on corporate jets

For years Warren Buffet spoke out against the concept of corporate jets as a waste of money. However, in 1985 he broke down and bought a used jet - only \$850K. He wrote in the annual report (1986):

“A[Corporate jets] not only cost a lot to operate, they also cost a lot just to look at. Pretax, cost of capital plus depreciation on a new \$15 million plane probably runs \$3 million annually...Whether Berkshire will get its money’s worth from the plane is an open question, but I will work at achieving some business triumph that I can (no matter how dubiously) attribute to it.” In a later annual report, Buffet reported buying a different plane for \$6.7 Million. He named it the indefensible. In a later letter to the shareholders (1990), Buffet wrote: *“Were I to die tomorrow, you could be sure of three things: (1) None of my stock would have to be sold; (2) Both a controlling shareholder and a manager with philosophies similar to mine would follow me; and (3) Berkshire’s earnings would increase by \$1 million annually, since Charlie would immediately sell our corporate jet, The Indefensible (ignoring my wish that it be buried with me)”*

How bad are non-pecuniary benefits?

- Sometimes not. If they motivate managers and are as cheap or cheaper than straight cash, then answer is no.
 - (1) What do the benefits cost you? Tax reasons.
 - (2) What are they worth to the firm? Their value to the firm is how much they reduce the other compensation demanded by the manager.
- Sometimes yes: Managers tend to choose the level of benefits and they have incentives to over consume. (e.g. Ross Perot and GM)

Possible managers' incentives (cont.)

- **Maximize Growth**, reasons:
 - (1) **Manager's compensation** is often tied to sales growth.
 - (2) **Middle level managers are often rewarded with promotions** rather than bonuses or wages.
 - (3) **Ego**. It is more fun and more impressive to run a large enterprise.
- ⇒ **free cash flow problem** (e.g. tobacco, oil companies).

Consequences: The Free Cashflow Problem

Managers of firms with few attractive investment opportunities reinvest the free cash flow of the firm into existing operations or diversification rather than pay out investors.

Some examples of firms with a free cashflow problem

- These are firms in industries that need to shrink. Cash cows with few profitable investment projects.
 - **Tires:** The development of radials in Europe, which last 3 time longer than bias-ply tires, meant the industry had excess capacity.
 - **Tobacco:** Firms have high earnings, but demand is falling 3 percent per year.
 - **Oil:** Oil prices rose ten fold in last half of 1970s and oil company profits were very high. At the same time, expected demand and so future prices were falling. 12

Empirical evidence of existence of conflicts of interests

- Evidence from Investment announcements (negative returns for oil companies)
- Evidence from takeover resistance (negative returns when managers resist)
- Evidence from diversification (negative returns on announcements in the 80s)
- Evidence from Sudden Executive deaths (positive returns in many cases)

Which companies are more exposed to the risk that managers do not maximize shareholder value?

Look for these characteristics:

- **Managerial job market.** For most CEOs this is the last job, it works better for young managers
- **Boards of Directors monitoring managers.** Do they really monitor?
- **Product market competition:** it is hard to be inefficient in a competitive markets, since the company does not have much resources to waste
- **Proxy fights and takeovers**

Aligning managers' and shareholders' interests

- **Give the manager a sufficiently large share of ownership or a “good” compensation package**

1. Potential problems

- **Wealth constraints.** With a salary of \$6.9 million per year Jeffrey R. Immelt cannot buy General Electric.
- **Diversification of risk.** This is a fundamental trade off: incentives versus risk. If you want greater incentives you must force more (idiosyncratic) risk on the manager. Since the manager is bearing more risk, you must pay the manager a higher average wage. This is the risk premium to compensate the manager for bearing risk. This is true even if the risk is idiosyncratic.
- **Other problem.** If managers become too rich they may begin using the resources of their companies to pursue personal objectives (Armand Hammer)

Aligning managers' and shareholders' interests

- **Give the manager a sufficiently large share of ownership or a “good” compensation package**

2. In practice we know:

- Empirically firm value is highest at 5 to 10% of management ownership.
- Typical U.S. CEO receives \$3.25 per \$1000 increase in shareholder wealth. They hold 0.25% of firm's equity. Lots of CEOs have a negative pay per performance.

Aligning managers' and shareholders' interests

- **Increase Debt (bonding mechanism)**
 - **Debt is a legal commitment to pay out cash flow.** The firm issues debt and pays the proceeds out to shareholders.
 - **But... debt can force major restructuring:** e.g. the firm is solvent, but illiquid.
- **Bank monitoring.** Dispersed bondholders suffer from free riding problems too. A large creditor may be a better monitor. What are the costs of having a large creditor?

Aligning managers' and shareholders' interests

- **A good example of a combination of debt and good compensation:**
 - **LBO.** A group of investors borrows most of the firm's value (>80%) and purchases the company. The firm's assets serve as collateral. (cost of fin distr. May be lower than for other firms.. Prompt intervention, less parties involved)
 - **Structuring the LBO:**
 - **LBO partnership.** They pick the deals and provide the expertise in structuring them. They also monitor management. Kohlberg, Kravis, & Roberts and Berkshire Partners are examples.
 - **Company managers.** They bring firm-specific knowledge to deals. They hold a substantial equity position. They usually include members of old management team although most commonly the younger ones.
 - **Institutional investors.** Serve as the limited partners who purchase some of the equity and a lot of the debt.

Why were LBOs successful?

Henry Kravis:

“And make sure that capital structure we have in place is the right capital structure. I think that's the reason that we've been successful. It's not just buying the company. Sure, we picked the right companies, and we picked the right management and, **most importantly, we've given them the right incentive to perform.** Management has been an owner, management has had their own equity on the line. They have something at risk. I always like to refer managers in corporate America as the renters of the corporate assets, not the owners.

.... If you have something at risk, you think differently. If you go out and rent an Avis rental car, and you put a scratch on it, you are not going to be that happy, but it's not going to really upset you that much. What you really want to do is get back to the Avis counter before they see the scratch. Whereas if you own your own car, and you put a scratch in that car, you are going to be out there polishing it, and making sure that scratch is gone. You are going to take extra special care. Exactly the same concept if you own the company, if you have your own money at risk. You start to say, "Do we really need all those people that we have in the company? Do we need as many airplanes?"

“RJR Nabisco, for example. We had 81 people in the flight department when we bought the company, and they had eleven corporate jets. Today we have 24 people in the flight department, and we have four planes. We've got one airport, versus four airports that the company had. You think differently.”

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Aligning managers' and shareholders' interests

- **Executive compensation in LBOs:**
 - Business unit chiefs in LBO hold 6.4% of equity. So excluding performance bonuses, they receive \$64 per \$1000 increase in shareholder value.
 - Members of LBO partnership they receive \$200 per \$1000 increase in firm value.
 - Compare with the average CEO

Aligning managers' and shareholders' interests

- **Dividends as a bonding device.** Better commitment than debt, because dividend cuts are punished by the stock market and the managerial labor market. Less commitment than debt because dividends can be cut or not increased.

Empirical evidence of the effect of aligning managers' and shareholders' interests

- **Capital structure changes.** On average, transactions which increase leverage result in stock price increases; transactions which lower leverage result in stock price declines. It should only be good, if the firm is below its optimal debt ratio.
- **Leveraged buyouts and going private transactions.** Large gains for current shareholders. Premiums paid to public shareholders were around 40 percent.

Summary of the lecture

- Understanding the conflicts of interests between management and shareholders
- The extent to which there are conflict of interest between manager and shareholders depends on characteristics of the firm (market competition, managerial compensation and ownership, Board of Directors) and legal and economic environment (anti takeover legislation, managerial job market)
- Understanding the ways to align management and shareholders' objectives (debt, dividends, allocation of debt and equity).

Summary of capital structure

- Consider the costs and benefits of debt
 - Benefits (Tax benefits, adds discipline to management)
 - Costs (bankruptcy costs, agency costs)
- Consider the costs of equity
 - underpricing with asymmetric information
- Consider the distribution of equity and the conflict of interest between managers and shareholders